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In the Supreme Court

of the United States

OCTOBER 1950 TERM

No. 392

SAM SCHNITZER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT and BRIEF IN SUPPORT THEREOF

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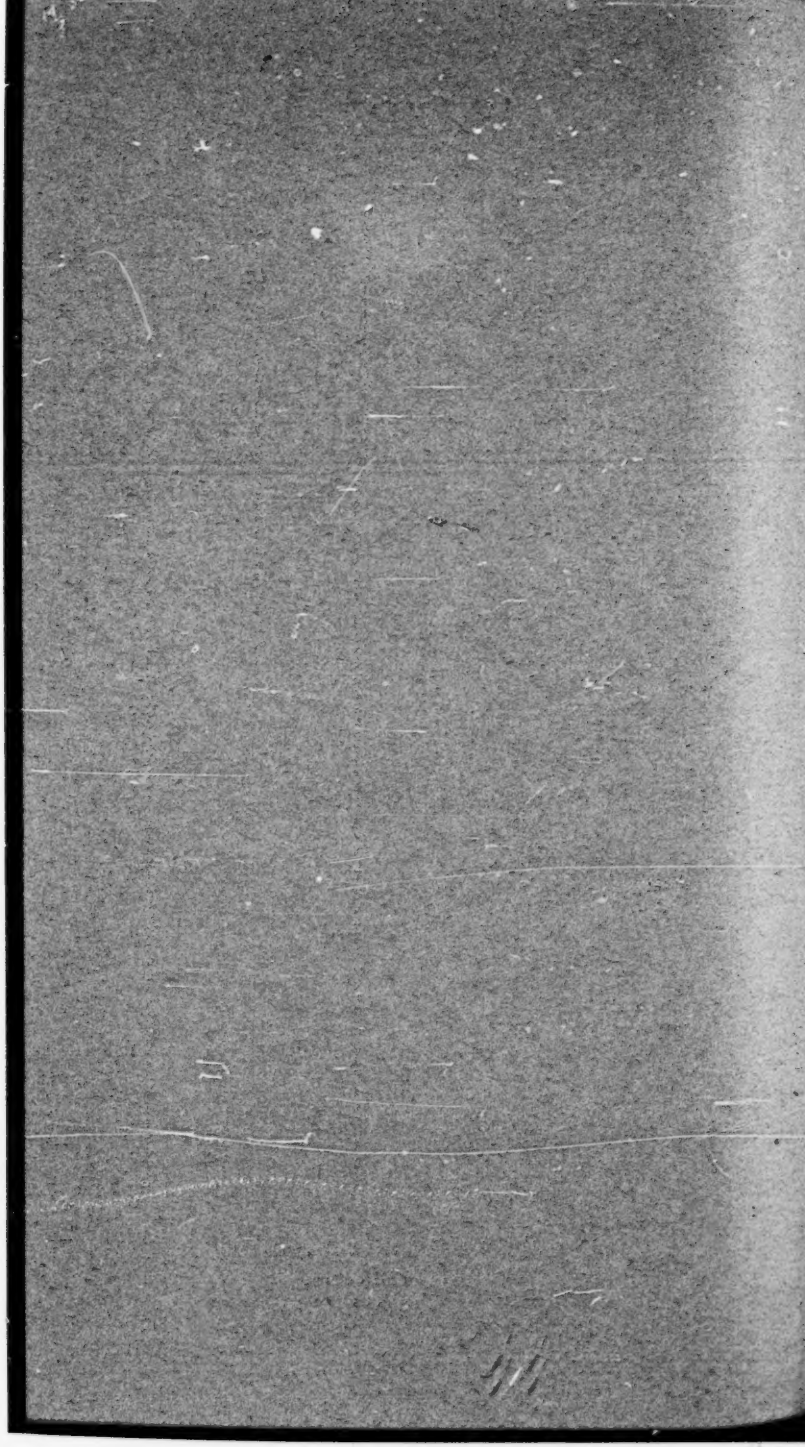

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In the Supreme Court of the United States

OCTOBER 1950 TERM

No......

SAM SCHNITZER, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MONTE L. WOLF, Administrator de bonis non with the Will annexed of the Estate of HARRY J. WOLF, Deceased, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MONTE L. WOLF, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BLOSSOM M. GOLDSTEIN, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

CHARLOTTE C. COHON, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MONTE L. WOLF, Administrator de bonis non with the Will annexed of the Estate of JENNIE WOLF, Deceased, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

TO THE HONORABLE THE SUPREME COURT OF THE UNITED STATES:

The petition of the petitioners above named present to the Court as follows:

OPINIONS OF THE COURT BELOW

The findings and opinion of the Tax Court of the United States (R. 28 to 70) are reported in 13 TC 43. The United States Court of Appeals for the Ninth Circuit rendered a per curiam decision affirming the Tax Court "upon the basis o the Tax Court's opinion". The per curiam memorandum is reported in 183 Fed. 2d 70.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered July 24, 1950 (R. 563). Rehearing was denied September 25, 1950 (R. 564). The jurisdiction of this Court is invoked under Section 1254 (1) U.S.C.A., Title 28 (Sec. 240 (a) of the Judicial Code) as amended by Act of June 25, 1948 c. 646, 62 Stat. 928.

QUESTIONS PRESENTED

1. Whether the deductions taken by petitioners from gross income in their income tax returns constitute "debts" within the purview of Sec. 23 (k) (l) of the Internal Revenue Code, or contributions to the capital of the corporation to and for whose account advances were made by the Alaska Junk Co. (a partnership of which petitioners were members) within the purview of Regulation 111, Sec. 29.22 (a) - 16 of the Treasury Department.

2. When stockholders of a corporation make advances to or for the account of the corporation under a consentual arrangement of debtor and creditor, can the Commissioner of Internal Revenue work an involuntary conversion of the indebtedness into a capital contribution?

STATUTES AND REGULATIONS INVOLVED

Title 26 U.S.C.A., Sec. 23 (k) (l), provides

> "DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> (k) BAD DEBTS.
>
> (l) GENERAL RULE. Debts which become worthless within the taxable year . . . ."

Treasury Department Regulation 111, Sec. 29.22 (a) 16, provides

> "If a corporation requires additional funds for conducting its business and obtains such needed money through *voluntary pro rata payments* by its shareholders, the amounts so received *being credited to its surplus account or to a special capital account,* such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company." (Emphasis supplied)

SUMMARY STATEMENT OF THE MATTERS INVOLVED

The petitioners appearing in their individual capacity and the decedents, whose estates are represented by administrators as petitioners, were, during the tax years in question members of a partnership, Alaska Junk Company, hereafter referred to collectively as "Alaska".

Alaska sold merchandise and advanced moneys to and for the account of a corporation, Oregon Electric Steel Rolling Mills, which will be referred to as "Oregon Steel". Alaska was during that time a stockholder in Oregon Steel.

During the tax year in question, the indebtedness from Oregon Steel to Alaska became worthless. The partnership, in filing its information income tax return and the members of the partnership in making their individual returns took a deduction of the worthless indebtedness from the gross income of the partnership.

The Commissioner of Internal Revenue disallowed the deduction, asserting that the merchandise sold by Alaska to Oregon Steel and the moneys advanced by Alaska to and for the account of Oregon Steel, constituted contributions to the capital of the corporation, Oregon Steel, and therefore the loss sustained by Alaska was not deductible as a bad debt.

The pertinent facts are as follows:

Alaska was for many years engaged in buying and selling old and new steel, scrap metal, machinery and

equipment (R. 33-34). During their operations, it frequently made loans of money and materials to various enterprises to aid them in procuring scrap metal and machinery, which they in turn could sell to Alaska. This was done to aid in insuring sources of supply of such materials (Findings R. 38, 39, 40, R. 189, 202).

Petitioner Sam Schnitzer had a son named Morris who was and had been engaged in a similar business on his own account (under the name of Schnitzer Steel Products Co.) since 1935 (R. 39, 80, 91). He was not an Alaska partner, had no interest in that partnership (R. 80) and is not one of the petitioners.

In 1941, Morris conceived the idea of constructing a plant to manufacture steel at Portland, Oregon. This idea originated with him (Findings R. 41, Test. R. 87).

It was contemplated (based on engineering advice) that the cost of constructing the mill, plus organization expense, etc., would be $700,000.00. This sum was to be raised by issuance of $250,000.00 capital stock and by obtaining a loan from financial institutions of about $450,000.00 (R. 108, 139). The loan was to be obtained by a promoter named Rosenbaum (R. 102), who was to be paid for his services 12½% of the stock to be issued (R. 90).

It was estimated by competent engineers that the mill would produce profits of $50,000.00 to $75,000.00 per month (Findings R. 41, Test. R. 93, 212, 253).

Alaska deemed it advisable to become a stockholder because the mill would become a favorable customer

for scrap metal sold by Alaska and a favorable source of supply for manufactured steel (R. 230, 231). Morris incorporated Oregon Steel with an authorized capital stock of $250,000.00 divided into 2,500 shares of par value of $100.00 per share. Morris subscribed for 1,251 shares (1 share in excess of 50% of the stock) because he wanted to retain control (R. 83). Alaska subscribed for 625 shares (¼ of the authorized capital stock) (R. 40). The remaining 25% of the stock was retained unissued for a specific purpose. 12½% of the stock was to be issued to Rosenbaum, the promoter, who undertook to procure for Morris the necessary capital with which to construct the plant in excess of the amount subscribed for the stock. This was to be his compensation for his services (R. 90). The remaining 12½% (except a few single shares allocated to nominal stockholders to qualify them as directors) was reserved for one L. G. Knight who was to become the manager and operator of the plant. He was to pay for that stock out of his salary and earnings on the stock (R. 90). This reserved stock was never issued.

Construction of the plant was commenced with materials and moneys supplied by Morris Schnitzer and Alaska before any financing arrangements were made. It developed that Rosenbaum, the promoter, was unable to procure the finances that were contemplated.

In the latter part of 1942, Morris Schnitzer concluded that he would not be able to carry 50% of the stock. Dissension also developed between the Sam Schnitzer family and the Wolf family with respect to this enter-

prise. The Wolf family objected to Alaska advancing any more money or materials, which were greatly out of proportion to the advances that had been made by Morris Schnitzer. The result was an agreement between Morris Schnitzer and Alaska by which Alaska took over one-half of Morris Schnitzer's stock subscription so that Alaska at that point became the subscriber to 1,250 shares—50% of the stock, par value $125,000.00; and Morris Schnitzer remained the subscriber to 625 shares —25% of the stock, par value $62,500.00 (Findings R. 46, 47, Test. R. 84, 86, 372, 373, 427, 437).

Up to November 30, 1942, Morris Schnitzer, who had subscribed for $125,100.00 and later reduced to $62,500.00 of the capital stock, had advanced $138,984.11 in money and materials to Oregon Steel ($13,884.11 in excess of his original stock subscription liability). Alaska, who had subscribed for $62,500.00 and later increased to $125,000.00 of the capital stock, had advanced $299,-069,70 to Oregon Steel ($236,569.70 in excess of its original stock subscription liability) (Oregon Steel ledger and Alaska ledger, Exhibits 26, 17).

It developed that the cost of constructing the plant greatly exceeded the amount originally contemplated. This was due in part to the inability to obtain funds, and in part by the increased cost of labor and materials because of the war conditions (Findings R. 49, Test. R. 114).

A loan of $700,000.00 was obtained from the Reconstruction Finance Corporation. The R.F.C. required that the indebtedness of Oregon Steel to Morris Schnit-

zer and Alaska should be frozen. This was accomplished by the execution by Alaska and Morris Schnitzer of "standby agreements" (Exs. C and D) by which it was agreed that no payments should be made to Morris Schnitzer and Alaska until the R.F.C. loan was paid, and by applying the advances made as aforesaid, first, to the payment of the stock subscriptions and the balance to be evidenced by debentures to be issued by Oregon Steel containing provisions postponing the payment of the indebtedness until the R.F.C. loan was paid with the result that of the indebtedness of $299,069.70 from Oregon Steel to Alaska $125,000.00 thereof was applied to the payment of the $125,000.00 for the 1,250 shares issued to Alaska, and the balance of the indebtedness, to-wit, $174,000.00, was evidenced by the issuance of debentures in that sum. A similar procedure was followed with respect to Morris Schnitzer and this liquidated the entire indebtedness from Oregon Steel to Alaska and Morris Schnitzer as of November 30, 1942 (Findings R. 46).

Between November 30, 1942 and November 26, 1943, Alaska sold to Oregon Steel materials that went into the construction and equipment of the plant and advanced to and for the use of Oregon Steel a total sum of $567,574.52 (Ledgers, Exs. 26, 17). During that same period of time Alaska received payments on account and credits from Oregon Steel totalling $149,-360.88, leaving a balance as of November 26, 1943, of $418,213.64 (Ledgers, Exs. 26, 17).

During that same period of time, Alaska sold scrap

metal to Oregon Steel which was carried in a separate ledger account (Ex. 18) in the sum of $9,460.53 so that the total indebtedness to Alaska from Oregon Steel as of November 26, 1943, was $427,843.87, which by reason of some adjustments totalled the sum of $428,132.13 (Findings, R. 50 and Exs. 17 and 18).

During the same period of time, Morris Schnitzer also advanced moneys to Oregon Steel and received payments on account with the result that on November 26, 1943, the balance of indebtedness from Oregon Steel to Morris Schnitzer was $26,829.28 (Findings, R. 50, Ex. 26).

This indebtedness from Oregon Steel to Alaska and to Morris Schnitzer was in addition to the indebtedness evidenced by the debentures. Oregon Steel issued notes to Alaska and Morris Schnitzer in the sums of $427,-843.87 and $26,829.28 respectively (Exs. 20, 21).

On November 26, 1943. Alaska and Morris Schnitzer sold their capital stock in Oregon Steel to A. M. Mears and Kenneth B. Hall, who elected new directors and officers and made a settlement with Alaska and Morris Schnitzer of the aforesaid debts. Oregon Steel issued to Alaska and Morris Schnitzer jointly its promissory note for $249,000.00 secured by a second mortgage on the assets of the corporation subordinate to the R.F.C. mortgage, and Oregon Steel executed a second note issued jointly to Alaska and Morris Schnitzer in the sum of $151,000.00 secured by a third mortgage on its assets subordinate to the R.F.C. mortgage. The note for $249,-000.00 was given to Alaska and Morris Schnitzer in ex-

change for the $249,000.00 of debentures which had been issued to them as aforesaid, and the $151,000.00 note was given to Alaska and Morris Schnitzer in settlement of the indebtedness totalling $454,625.90 to Alaska and Morris Schnitzer incurred subsequent to the issuance of the debentures and carried on the books of Oregon Steel and Alaska as an open account. This resulted in a loss to Alaska and Morris Schnitzer jointly of the sum of $303,635.90 (Findings R. 51). By reason of adjustments between Alaska and Morris Schnitzer, Alaska's loss was reduced to $202,350.60. Alaska charged off in the year in question this bad-debt loss on its books (Findings R. 52).

All of the transactions between Alaska and Oregon Steel were carried on in the ordinary and usual course of business. The merchandise was sold to Oregon Steel at regular market prices (R. 95, 96, 371). The business of the two organizations was carried on separately and distinctly in separate plants and under separate management. The accounts of each organization were maintained separately by separate accounting staffs. On the books of Oregon Steel, Alaska was credited with all merchandise purchased from Alaska and with all advances made by Alaska to or for the account of Oregon Steel. Alaska was debited in said accounts with the amount of the debentures and the purchase price of the stock which liquidated the indebtedness as of November 30, 1942, and Oregon Steel credited Alaska with all purchases made from Alaska subsequent to November 30, 1942, and with all moneys advanced by Alaska to or for

its account. Oregon Steel debited Alaska with all payments which it made to Alaska during the period of time, and the balance which was charged off on the Alaska's books was the balance of the open account carried on the books of Oregon Steel and Alaska showing debtor and creditor relationship between them.

There is in evidence photostatic copies of the Oregon Steel account books consisting of journal entries, ledger accounts, stock purchase accounts, etc., which accurately reflect these transactions and the accounting records of Alaska, photostatic copies of which are in evidence, in like manner recorded all of the transactions.

Balance sheets of Oregon Steel are in evidence (Exs. X, Y and Z and Ex. 19). They reflect the indebtedness to Alaska as liabilities. The outstanding debentures appear as liabilities. The "capital stock and surplus" accounts do not include the debentures or the advances from stockholders. The balance sheets also show the "capital stock and surplus" accounts and disclose that the capital stock account is $187,500.00 and capital surplus of $8,891.48, showing conclusively that the debentures and the advances from stockholders were treated as debts by Oregon Steel and not contributions to capital.

The advances of material and moneys made by Alaska to Oregon Steel were at no time in proportion to the stock subscription or ownership. During the time that Alaska's subscription to the stock totalled $62,500.00 it advanced $299,069.70, or $236,569.70 in excess

of its stock subscription liability. During that same period of time while Morris Schnitzer's subscription was $125,100.00, he advanced $138,577.15 or $13,477.15 in excess of his stock subscription.

Subsequent to the change in stock subscriptions and while Morris Schnitzer was the owner of $62,500.00 of stock, he advanced $26,493.77, or 42% of his stockholdings. During that same period of time while Alaska was the owner of $125,000.00 of the capital stock, its net advances to the corporation were $428,132.13 or about four times the amount of its capital stock investment (Ledgers, Exs. 26 and 17).

The amounts of the various advances and credits are not in issue.

Oregon Steel was not a wholly owned subsidiary of the partnership, nor was it organized or maintained as the alter ego of the partnership. The Courts below did not hold that the doctrine of "ignoring corporate entity" or "piercing the corporate veil", was applicable. It is not charged that there was any fraudulent purpose in the formation of the corporation, in the manner in which it was financed, or in the manner in which its accounts were maintained by the corporation and by Alaska, or that it constituted a scheme to avoid or evade taxation.

No increase in capital stock was ever made or ever contemplated. No stock was issued beyond the original subscription of $187,000.00.

It was not contemplated that the remaining 25%

of the treasury stock should ever be issued except for the specific purposes for which it was reserved (Findings R. 48—R. 87-88, R. 374).

When the R.F.C. made the $700,000.00 loan and imposed as a condition that the stockholders obligate themselves to supply any additional capital that might be needed to complete the plant, it did not insist or require that such additional advances should be made as capital contributions and that they were to take additional stock therefor.

Oregon Steel was not conceived or launched by Alaska or its partners. It was conceived and organized by Morris Schnitzer (Findings R. 40, 41—R. 83, 87).

It was not contemplated at the inception that Alaska should be the owner of any more than 25% of the stock (R. 89, 123-125, 187).

There is no finding by the Commissioner or by the Tax Court that the transactions resulting in the loss were sham or that there were manipulations of the books for the purpose of tax evasion or avoidance. There is no finding of fact challenging the good faith of the transactions in any respect whatsoever.

The indebtedness from Oregon Steel to Alaska is recognized and acknowledged by Oregon Steel in its books of account maintained in the regular and ordinary course of business and by the execution of its notes to Alaska and to Morris Schnitzer in the sums of $427,-843.87 and $26,829.28 respectively (Exs. 20 and 21) and was recognized by the new stockholders when they ac-

quired the stock and negotiated the settlement of the obligations (Findings R. 51).

The findings of fact of the Tax Court confirm all of the facts narrated herein, but it *drew the inference* that all of the advances constituted contributions to capital from certain evidentiary circumstances which will be discussed hereafter.

The evidence establishes (R. 189 to 202 and 290 to 369) and the Tax Court found as a fact (Findings R. 38 to 40) that Alaska had for many years as a part of its business operations made advances of money and materials to persons, firms and corporations to aid them in their business so that Alaska would have a steady and favorable source of supply of scrap metal, etc. For a period of thirty years all such transactions were handled on the basis of debtor and creditor relationship. They were carried on Alaska's books in accordance with that relationship and in the same manner as the advances to Oregon Steel.

Alaska expected to be paid for all advances in excess of its liability on the stock subscription in the regular course of business because it was estimated on reliable engineering authority that the profits of Oregon Steel would be from $50,000.00 to $75,000.00 a month (Findings R. 41—R. 93, 212 and 253).

The Wolf family agreed with the Schnitzer family that Alaska would only invest $62,500.00 for 625 shares (R. 372). It was only after Morris Schnitzer made known that he would be unable to carry the 1,251

shares that it was agreed that Alaska would take one-half of his stock subscription off his hands (R. 84 and 372). The Wolf family did not want to invest any more in the stock of Oregon Steel (R. 373).

The stipulation of facts (R. 535) recites

> "On November 26, 1943, Oregon Steel executed and delivered to Alaska Junk a promissory note in the amount of $427,843.87 *as evidence of the advances made to it by Alaska Junk as of that date, shown by the books of Oregon Steel.*" (Emphasis supplied; Exhibit 20 is a photostatic copy of said note)

Notwithstanding these facts all of which are established by the findings and the evidence, the Tax Court drew the inference that the advances of the materials and moneys by Alaska to Oregon Steel were "paid in as risk capital" and constituted contributions to the capital of the corporation. This was predicated upon the following circumstances:

a. Morris Schnitzer and Alaska agreed between themselves individually that Morris Schnitzer would reimburse Alaska for any loss that might be sustained in excess of 2/3 of the joint total loss of Morris Schnitzer and Alaska and "the mere existence of such an agreement is incompatible with testimony that repayment of the advances was anticipated or with their characterization as loans." (T.C. Opinion R. 62 and 69).

b. That the amount of capital represented by subscriptions to the stock of the corporation was

"only a fraction of the minimum requirements for construction of a steel mill" (T.C. Opinion R. 65).

c. There was some bookkeeping delay in posting the entries in the ledger accounts crediting Alaska's stock subscription account and debiting the open account with the amount of Alaska's stock subscription liability (T.C. Opinion R. 67-68).

d. The parties referred to the advances as capital investments in some communications addressed or delivered to the R.F.C. (Findings R. 45).

The Tax Court and the Court of Appeals in affirming the Tax Court committed error of law in holding these circumstances individually or collectively were relevant and dissipated the debtor and creditor relation, as will be demonstrated in the Brief included herein.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

There are special and important reasons why a Writ of Certiorari should be granted in this case. They are,

1.

The United States Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court.

Section 23 (k) (l) of the Internal Revenue Code provides that

> "In computing net income, there shall be allowed as deductions . . . debts which become worthless within the taxable year."

Treasury Regulation 111, Sec. 29.22 (a)-16 defines "contribution to capital". The text is quoted at page 3.

The Tax Court of the United States and the United States Court of Appeals for the Ninth Circuit in affirming the Tax Court have decided in the case at bar that the Commissioner of Internal Revenue could work an involuntary conversion of a *debt*, created through the consentual relation of debtor and creditor into a *capital investment* in the stock of the corporation, notwithstanding the fact that the parties as between themselves in fact and in law created a debt, recognized as between themselves the relationship of debtor and creditor, Oregon Steel did not "credit to its surplus account or to a special capital account" the advances made to it by Alaska and the advances were not "voluntary" contributions but were loans and advances made with the intention that they should be repaid in any event.

The question whether the Commissioner may do so under the statute and regulation referred to, is an important question of federal law which has not been, but should be, settled by this Court.

The question is of great importance to businessmen. It has been recognized that one has a right to determine for himself how much of his money he is willing to risk by investment in the capital stock of a corporation and how much of his money he is willing to loan to the corporation so that he could participate on a parity with

other creditors in the distribution of the net assets of the corporation prior to any distribution to stockholders, in the event of the liquidation of the corporation. It is generally assumed that when one makes that choice he does not subject himself to the hazard that the Commissioner of Internal Revenue may thereafter by reason of posthumous events convert his status as a creditor into that of a contributor to the capital of the corporation against his will.

The Commissioner of Internal Revenue did in this case make this involuntary conversion and the Tax Court of the United States and the United States Court of Appeals for the Ninth Circuit by affirming the determination held that he has the power to do so. They have by these determinations introduced uncertainty into the relationship between the stockholder and the corporation so that the stockholder is left in doubt as to whether his loans to the corporation will be treated as such or converted into capital contributions.

It is important that stockholders of corporations or those who are about to become stockholders of corporations should know what their rights are in this respect. Their rights should not depend upon the future determination of the Commissioner of Internal Revenue in the event that the corporate venture has to be liquidated, who can, after the event assert that what, in fact is a loan, is a contribution to the capital of the corporation.

This Court has not passed on this question. It has not construed the word "debt" as used in the statute referred to above or construed the words "capital con-

tributions" as defined in the aforesaid Treasury Regulation, nor has this Court rendered any decision bearing upon the powers of the Commissioner of Internal Revenue with respect to the determination as to what is or is not an indebtedness.

If the Commissioner of Internal Revenue is under this statute deemed to have the right to convert a debt into a capital contribution, there ought to be a judicial determination as to the circumstances or landmarks governing such involuntary conversions. It ought to be known whether the status of debtor and creditor is to be determined as of the date of the advances or by reference to posthumous events.

The public interest will be promoted by the prompt settlement of the question involved in this case. It affects the launching of new enterprises in which the financial structure is to consist in part of investment in the capital stock of the corporation, and in part by loans to be made by stockholders to the corporation. It includes enterprises in which loans by stockholders are contemplated from the inception as well as loans which the stockholders are compelled to make to the corporation by reason of the failure to obtain loans from other contemplated sources. In these situations the stockholder should be able to determine at the time when he makes the loans whether the Commissioner of Internal Revenue may thereafter convert the loans into capital investments and if so, under what circumstances.

2.

The Tax Court of the United States and the United

States Court of Appeals of the Ninth Circuit have in this case decided a federal question in a way probably in conflict with an applicable decision of this Court.

In the case of *John Kelley Co. vs. Commissioner of Internal Revenue,* 326 U.S. 521, this Court had under consideration a deduction taken by the taxpayer under Section 23 (b) of the Internal Revenue Code which permits the deduction from gross income of "interest paid or accrued within the taxable year on indebtedness . . . ."

In that case the members of a family owned all of the common and preferred stock of a corporation. The preferred stock provided for the payment of dividends at a fixed rate. The corporation was reorganized by authorizing the issuance of interest bearing debenture bonds, a portion of which were exchanged for the original preferred stock. This was done for the avowed purpose of enabling the corporation to take the interest payments as a deductible expense. The corporation paid interest on the debentures and took the payment as a deduction from gross income. The Commissioner disallowed the deduction contending that the debenture bonds were in reality contributions to capital and the interest therefore constituted dividends to the stockholders holding the debenture bonds. *The Tax Court reversed the Commissioners* (1 T.C. 457). The United States Court of Appeals for the Seventh Circuit reversed the Tax Court (146 F. 2d 466). This Court granted Certiorari and reversed the United State Court of Appeals and sustained the Tax Court decision which

rejected the determination of the Commissioner.

Although the *Kelley* case involves a deduction of interest under Subdivision (b) it necessarily requires a determination of the question whether the debentures were in law or in fact debts, thus presenting the same question that is involved in the case at bar. In the *Kelley case*, the debentures were referred to on the books of the corporation as "stocks, bonds and notes". In the capital stock tax returns, they were referred to as "capital stock". The debentures were *not reflected in the balance sheets* but appeared under the heading of "capital stock debenture notes".

The Tax Court in rejecting the Commissioner's determination held:

> "It is apparent that the *holders of the preferred stock, in exchanging the stock for* '20 year 8% income *debentures,' preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the right to change to the creditor-debtor basis, though the reason may be purely personal to the parties concerned. Commissioner v. Proctor Shop, Inc.*, 82 Fed. (2d) 792 (C.C.A., 9th Cir.), affirming 30 B.T.A. 721." (Emphasis supplied)

The United States Court of Appeals in reversing the Tax Court attached significance to the fact that the debentures were referred to on the books of the company as "stocks, bonds and notes" and as "capital stock" in the capital stock tax return, and to the fact that they were not reflected in the balance sheets.

This Court held that there was evidence to support

the Tax Court determination that the debentures were debts, because they had the "indicia of indebtedness".

It is not entirely clear whether this Court affirmed the Tax Court and reversed the Court of Appeals by reason of its own determination that the debentures under the facts in that case constituted an indebtedness or whether this Court reversed the Court of Appeals and affirmed thet Tax Court solely on the ground that the Court of Appeals was precluded from rejecting the determination of the Tax Court under *Dobson vs. Commissioner*, 320 U.S. 489.

The *Kelley case* was decided prior to the amendment of May 24, 1949, c. 139, Sec. 128, 63 Stat. 107 to Sec. 1141 (a) U.S.C.A., Title 26, which authorized the Court of Appeals to review the decision of the Tax Court "in the same manner and to the same extent as decisions of District Courts in civil action tried without a jury".

Since the Court of Appeals was required to review the Tax Court decision in the case at bar in the manner set forth in the 1949 amendment, this Court could now review the decision to the same extent. The scope of review is no longer limited by *Dobson vs. Commissioner* and this Court could now for the first time pass upon the question involved.

If this Court intended in the *Kelley case* to pass upon the question whether the debentures constituted an indebtedness, then the decision in the case at bar is in conflict with the decision of this Court in the *Kelley case*.

There is greater reason for recognizing the relation of debtor and creditor in the case at bar, because the indebtedness involved did not result from a substitution by the corporation of debentures for outstanding stock. The indebtedness resulted from actual sale of merchandise and the loan of money. It was not a substitution of one relationship for another. The debtor-creditor relationship was created at the inception of the transaction—at the time the advances were made.

Indeed, the facts are also stronger in the case at bar because the indebtedness was reflected in the balance sheets of the corporation as a liability and was carried on the account books of the corporation as a liability, and as accounts receivable (debts) on the books of account of the creditor.

The Tax Court in that case recognized the right of the stockholder to change his status from that of stockholder to that of a creditor if he preferred to do so without regard to the reason therefor on the authority of *Commissioner vs. Proctor Shop, Inc.*, 82 F. 2d 792 (9th Circuit).

This Court impliedly recognized that right. At least, it did not reject or question the Tax Court's declaration of that legal right.

So that if the decision of this Court in the *Kelley case* is regarded as an expression of the views of this Court upon the basic question involved, the decision of the Court of Appeals in the instant case was clearly contrary to the decision of this Court in the *Kelley case*.

If, however, it is held that the decision in the *Kelley case* was not intended as an expression of this Court's views on the basic question, then we submit that the question should be passed upon and determined by this Court. The case at bar presents the opportunity to determine the scope of the Commissioner's authority to convert a debt into a capital investment and the landmarks by which he should be governed in making such determination.

3.

The decision of the United States Court of Appeals in this case is in conflict with several decisions rendered by that Court and by Courts of Appeal of other Circuits on the same matter.

The decision in the case at bar is in conflict with the following 9th Circuit cases:

Wilshire & Western Sandwiches, Inc. vs. Commissioner, 175 F. 2d 718—1949.

Maloney v. Spencer, 172 F. 2d 638—1949.

Commissioner of Internal Revenue vs. Proctor Shop, Inc., 82 F. 2d 792—1936.

Nicolai vs. Commissioner, 42 B.T.A. 899; affirmed 126 F. 2d 927.

The decision in the case at bar is in conflict with the following decisions in other Circuits:

United States vs. Collier, 104 F. 2d 420 (5th Cir.) —1939.

VanClief vs. Helvering, 135 F. 2d 254 (C.C.A., D.C.)—1943.

Moore vs. Commissioner, 101 F. 2d 704 (2nd Cir.)—1939.

Commissioner vs. O.P.P. Holding Corp., 76 F. 2d 11 (2nd Cir.)—1935.

Commissioner vs. Hemenway-Johnson Furniture Co., T.C. Memo Decisions—1948, No. 48113; Affirmed 174 F. 2d 793 (5th Cir.).

Commissioner vs. H. P. Hood & Sons, 141 F. 2d 467 (1st Cir.).

CONCLUSION

For the foregoing reasons, petitioners respectfully pray that their petitions for Writ of Certiorari should be granted.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

The issue in this case is whether the deduction from gross income taken by petitioners in their income tax returns are "debts" within the meaning of Section 23 (k) (l) *Internal Revenue Code* (quoted page 3), or capital contributions as defined in Treasury Regulation 111, Sec. 29.22 (a)-16 (quoted page 3).

Oregon Steel was not a corporation wholly owned by petitioners for they originally subscribed for only 25% of the authorized capital stock and Morris Schnitzer (the progenitor of the corporation, who was not a petitioner and not a member of the partnership), subscribed for one share in excess of 50% of the capital stock. Later Alaska took over one-half of Morris Schnitzer's subscription so that it became the owner of one-half and Morris Schnitzer one-fourth of the stock. One-Fourth of the authorized stock remained unissued, being reserved for a specific purpose.

This case does not involve the doctrine of "ignoring corporate entity" or "piercing the corporate veil".

The issue is also free from any imputation of fraud or sham. There is no finding or intimation that there was any fraud or sham in the transactions between petitioners and Oregon Steel in the sale of merchandise and the making of the advances of merchandise and money by Alaska to Oregon Steel, or in the manner in which the transaction was carried out.

There is no intimation in the record that the transactions were devised for the purpose of *tax avoidance or tax evasion,* or that there was any tax implication involved in the manner in which the transactions were carried on between Alaska and Oregon Steel.

This case is unlike the class of cases in which the corporation distributed dividends on "preferred stock" and took a deduction of the dividends as "interest" on indebtedness.

> *Pacific Southwest R. Co. vs. Commissioner,* 128 F. 2d 815 (9th Cir.).
>
> *Commissioner vs. Meridian and T. R. Co.,* 132 F. 2d 182 (9th Cir.).
>
> *U. S. vs. South Georgia Ry. Co.,* 107 F. 2d 3 (5th Cir.).

This case is unlike the class of cases in which the taxpayer corporation issued interest bearing debentures to its stockholders *in exchange for the surrender of its preferred stock* (dividends not deductible) for the avowed purpose of enabling the corporation to take the interest as a deduction. The *Kelley* and *Talbot-Mills cases,* 326 U.S. 521 *are typical.* Even in this type of cases, the debentures were held to create a debtor-creditor relationship if they were payable in any event and not limited to payment out of earnings (*Kelley and Talbot cases*).

Here, we have a simple transaction between petitioners and Oregon Steel in which the partnership sold merchandise and advanced money to tide over Oregon Steel until such time as it could procure the permanent

financing from financial institutions with which to build and equip the steel mill as was contemplated from the very inception.

It was intended from the inception of the corporate venture that the construction of the plant was to be financed by loans to be obtained from financial institutions in an amount in excess of the $187,000.00 of capital stock subscriptions. It was not contemplated at the inception or at any time thereafter that the cost of constructing the plant should be raised by the issuance and sale of *additional* capital stock. Therefore, the authorized capital stock of the corporation was never increased beyond the amount originally authorized and none was ever subscribed for or issued beyond the original $187,000.00. Even the 25% of the reserve stock originally reserved for the promoter, Rosenbaum, and for Knight, prospective manager, was never issued. Indeed, one-half of the partnership (the Wolf family) was violently opposed to the enlargement of the original stock subscription of the partnership.

The situation was simply this. The stockholders commenced furnishing merchandise and money before a loan was obtained to set the project in motion, expecting to be reimbursed when the loans were obtained and from the operation of the plant when completed. Alaska was Oregon Steel's temporary banker. It was estimated on competent engineering authority that the revenue would be from $50,000.00 to $75,000.00 a month. The efforts to procure the loan proved futile. They were, therefore, compelled by necessity to advance additional

merchandise and funds (much against their desires and with detrimental effect to the partnership's financial status) until such time as a permanent loan could be obtained.

By the time the $700,000.00 R.F.C. loan was consummated, the mill could no longer be constructed within the original contemplated figure of $700,000.00 due to delays and the increased cost of labor and materials resulting from the war conditions. In order to obtain the $700,000.00 loan, petitioners were compelled to obligate themselves to supply any funds necessary for the completion of the plant in excess of the $700,000.00 loan. The R.F.C. did not *compel* Alaska to advance the additional capital *only by means of additional stock investment*. They had the choice of furnishing additional funds by taking "either stock at par *within* the *amount authorized*, or debentures in said form at par" (Ex. S).

Now at that time, there was no additional authorized stock to be issued, for the unissued authorized stock only amounted to $62,500.00 which was reserved for Rosenbaum and Knight whereas, the additional advances were in excess of half a million dollars. It would have necessitated increasing the authorized capital stock of the corporation if petitioners had elected to make further capital contribution on a stock basis.

> "Advances are additional contributions of capital if they are intended to enlarge the stock investment but not if they are intended as a loan."
>
> *Maloney v. Spencer*, 172 F. 2d 638 (9th Cir.).
> *VanCliet v. Helvering*, 135 F. 2d 254.
> *Katzinger v. Commissioner*, 44 B.T.A. 532.

Petitioners elected to make the advances on the debtor-creditor basis. They had the right to make this election. (*Kelley case,* 1 T.C. 457, affirmed by this Court.) The issuance of debentures in the form referred to in that document (Ex. 5) of course, is evidence of a debtor-creditor relationship for by their terms they created *a definite obligation payable in any event.* The fact that debentures were not issued after the R.F.C. loan for the additional advances totalling over one-half million dollars was made, is of no consequence, for the only one that could complain of the failure to evidence the additional indebtedness by debentures was the R.F.C. That institution was apparently unconcerned about the fact that the debentures were not issued to evidence the additional advances. The omission did not change the debtor-creditor relationship which resulted from the additional advances and sale of merchandise.

The course of conduct between the parties was in all respects entirely consistent with the debtor-creditor relationship. From the very beginning, all advances of merchandise or money were *contemporaneously recorded* in the books of account of both debtor and creditor from day to day as they were made. As of *November 30, 1942,* the total advances made by petitioners was $299,069.70, (see entry in Oregon Steel ledger, Ex. 17, under that date) being $174,069.70 in excess of their stock subscription liability of $125,000.00. Contemporaneously with the negotiation of the R.F.C. loan and as a part of the same transaction, it was agreed (Exs. A, R, S) that the balance should be applied as follows:

$125,000.00 in payment of the stock subscription liability and $174,000.00 by the issuance of the debentures in the form approved by R.F.C. (Ex. 5). The difference of $69.70 was carried over into the open account.

After the $299,000.00 balance was liquidated as aforesaid, Alaska made the further advances of merchandise and funds now in question. These transactions were likewise entered on the books of both debtor and creditor contemporaneously (ledger accounts, Exs. 17 and 26). During that period of time, Alaska received payments and credits on account as follows (Ex. 17):

December 31, 1942	$12,820.10
December 31, 1942	20,000.00
January 31, 1943	31,353.82
February 2, 1943	9,097.12
March 31, 1943	29,421.49
June 11, 1943	7,273.20
August 13, 1943	6,000.00
September 15, 1943	6,500.00
October 29, 1943	3,213.75

In Oregon Steel's monthly balance sheets (Exs. 19, X, Y & Z), these advances as well as the outstanding debentures were carried as liabilities and the "capital stock and surplus" statements appearing therein did not include the advances as "surplus".

The balance sheet of Octobe, 1943 (Ex. 19), is typical. The assets were broken down into "current assets", "property, plant and equipment" and "deferred charges".

The liabilities are broken down into sub-heads "Accounts Payable", "Notes Payable", "Accrued Expenses", "Advances from Stockholders" and "Funded Debt"

which is in turn broken down into "R.F.C. Loan" and "Debentures". The advances from stockholders of $457,-825.47 represents the liability to both Alaska and Morris Schnitzer and the debentures of $249,000 represents the amount issued to both Alaska and Morris Schnitzer.

Under the caption of "capital stock and surplus", there is only listed the outstanding capital stock of $187,-800.00 and a trifling sum as surplus ranging from $1,000.00 to $8,000.00 in the several balance sheets. *The liabilities to the stockholders are not included in the surplus account.*

On November 26, 1943, Oregon Steel issued its notes to Alaska and Morris Schnitzer (Exs. 20 and 21) for the amount of the balances on open account to that date.

After the sale of the stock by Alaska and Morris Schnitzer the new owners recognized the liability (Resolution, Ex. 22) and made a settlement of the liabilities.

This course of conduct is clearly consistent with the original intention of the petitioners to advance money and merchandise only on the debtor-creditor basis.

Re Regulation 111, Sec. 29.22 (a)-16

We submit that under Regulation 111, Sec. 29.22 (a)-16 (quoted page 3) the advances made by petitioners to Oregon Steel cannot be converted into capital contributions. Under that Regulation in order that advances may be treated as "contributions to capital", three elements must coincide: (a) the contributions must

be *"voluntary"*, (2) they must be *"pro rata payments by its shareholders"*, and (c) the amounts received by the corporation must be *"credited to its surplus account or to a special capital account"*.

None of these elements are present in the case at bar. The advances were not made as *voluntary capital contributions*. They were voluntary loans. To satisfy that element, there must be evidence that the stockholders voluntarily elected to make the advances as contributions to capital. It does not authorize an involuntary conversion of loans into capital.

The second element is not present because Alaska did not make advances to Oregon Steel in proportion to its stock ownership (demonstrated at pages 11-12).

The third element is not present because Oregon Steel did not credit the advances to *"its surplus or to a special capital account"*. This is established affirmatively by the four balance sheets in evidence (Exs. 19, X, Y & Z) which show that these advances were not included in the "surplus account" set forth therein or in any "special capital account".

This is also demonstrated by reference to the Oregon Steel general ledger (Ex. 17) which shows that the advances were carried as liabilities and not credited to any surplus account.

We believe this Regulation precludes the conversion of the advances into capital contributions.

Re Decisions of U. S. Courts of Appeals and Tax Court

The Courts of Appeal in a number of the Circuits and the Tax Court have in many instances held that relation of debtor and creditor created by the parties inter se could not be converted into capital contributions where the essential facts were less favorable than the facts in the case at bar. The decision in the case at bar is in conflict with the principles established in those cases. They are:

Wilshire & Western Sandwiches, Inc. vs. Commissioner, 175 F. 2d 718 (9th Cir.).

Maloney vs. Spencer, 172 F. 2d 638 (9th Cir.).

Commissioner vs. Proctor Shop, 82 F. 2d 792 (9th Cir.).

Commissioner vs. O.P.P. Holding Corp., 76 F. 2d 11 (2nd Cir.).

U. S. vs. Collier, 104 F. 2d 420 (5th Cir.).

Van Clief vs. Helvering, 135 F. 2d 254 (C.C.A., (D.C.).

Nicolai vs. Commissioner, 42 B.T.A. 899, affirmed 126 F. 2d 927 (9th Cir.).

Moore vs. Commissioner, 101 F. 2d 704 (2nd Cir.).

Fairbanks, Morse & Co. vs. Harrison, 63 F.S. 495.

Edward Katzinger Co. vs. Commissioner, 44 B.T.A. 533.

Gimbel vs. Commissioner, 36 B.T.A. 539.

Spreckels vs. Commissioner, 1949 T.C. Memo Opinions No. 49299.

Ohio Oil Co. vs. Commissioner, 1942 B.T.A. Decisions No. 42024.

Berry Motor Car Co. vs. Commissioner, 1941 B.T.A. Decisions No. 41071.

Ewing vs. Commissioner, 1946 T.C. Memo Decisions No. 46235.

Macy vs. Commissioner, 1949 T.C. Memo Decisions No. 49009.

Commissioner vs. Hemenway-Johnson Furniture Co., 1948 T.C. Memo Decisions No. 48113.

Commissioner vs. H. P. Hood & Sons, Inc., 141 F. 2d 467 (1st Cir.).

In the *Wilshire case, supra,* the Court of Appeals reviewed the decision of the Tax Court under the enlarged scope of review authorized by the 1949 amendment, and reversed the decision of the Tax Court which held that the advances constituted capital contributions instead of a deductible indebtedness. In that case, the stockholders of the corporate taxpayer made loans to the corporation *in proportion to their stockholdings.* Promissory notes were executed by the corporation in favor of the stockholders. At the time of incorporation, the *stockholders knew* that the *amount of authorized capital stock would be insufficient to pay for the construction and equipment of the project contemplated.* There was a considerable amount of informality in the recordings of their transactions so that the books did not in all respects correctly record the transactions as they took place, but ultimately correct entries were made which reflected the true state of affairs. The loans were not originally set up in the corporate books as in-

debtednesses, but subsequently entries were made reflecting the debts. The balance sheet also failed to reflect the loans, but it was shown that this was due to error on the part of the bookkeeper. This Court held:

> "It is not contended that a corporation is without power to enter into a debtor and creditor relationship with its stockholders. *The intent of the parties as to the nature of the transaction controls.*
>
> "The Tax Court found the parties intended to make advances for stock and loans on an equal basis, a plan which was subsequently modified only in the proportion of stock and loans. Yet the Tax Court, from inferences drawn by it from other facts and circumstances seems to have concluded that the original intent of the parties was nullified. The facts thus relied on appear to be the following:
>
> "That the 'loans' were not secured; that no initial receipts were given for the advances; that the division between the amounts of the loan and the capital stock was slightly modified from the first plan; that the amount loaned by each incorporator was in proportion to his holdings of stock; that interest was not paid when due; that the final payment of principal was late; that the initial book entries did not treat the advances as loans; and that the payments of interest and principal were made from the profits of petitioner, as the incorporators expected.
>
> "No conclusion inimical to the creation of a debtor-creditor relationship can justifiably be drawn from the manner in which the book entries were made, since it was found that the error was the result of the accountant's misinformation, and that the entries were corrected when detected.
>
> "To us other actions complained of seem consistent with a valid debtor-creditor relationship. Under the circumstances no adverse inference should

be drawn from the failure of the stockholders to demand payment immediately when due. The same strict insistence on payment on due date as would be the case if a bank were the creditor, should not be expected. It is not suggested that the sole shareholder of a corporation cannot become its creditor. See, Maloney v. Spencer, 9 Cir., 172 F. 2d 638. The effect of a lending and investing transaction giving creditors, as stockholders, proprietary interest in proportion to their loans, subjects the transaction to close scrutiny, but does not, as a matter of law, require the transaction to be treated as a stock investment, regardless of intent.

. . . . . .

"Respondent asserts that the transactions under consideration here have few of the characteristics of the people dealing at arms length. Whatever view may be taken as to the number of those characteristics, the controlling fact remains that those which appear are the essentials of a bona fide transaction. In reaching this conclusion we think we are *dealing with substance and reality* and not mere form, a requirement in the field of taxation.

"While it may be said that there are features looking both ways as to whether the advancements in this case were loans or stock purchases those sustaining a conclusion that the transaction was a loan greatly preponderate, chief of which as we have stated, is the intent of the parties at the time of entering into the transaction, which stamps it as a loan, the interest on which was deductible under § 23 (b).

"Reversed." (Emphasis supplied)

In the *Maloney case, supra,* the pertinent and comparable facts were as follows:

The taxpayer was the sole stockholder of the corporations to which the loans were made. He incor-

porated the three corporations and individually entered into leases with the corporations covering certain properties of which he was the owner. The corporations were to carry on canning operations. In the leases, the taxpayer agreed "to provide adequate financing" for the corporations. The corporations started with no cash for operations; the taxpayer hoped and expected that the corporations could obtain funds to finance their operations from other sources, but they were unable to do so. He mortgaged his own property to obtain funds or credit for them. The books of the stockholder and of the corporations reflected the debtor and creditor relationship. On the question of whether the funds advanced by the sole stockholder, were loans or capital contributions the Court held:

> "The sums paid in the last fiscal year by taxpayer on the notes signed and for the corporations' debts secured by him appear as debts due the taxpayer, both on his books of account and those of the corporation. They were paid as a part of the leasehold agreements. The question is what was the taxpayer's intent in agreeing to pay them. *VanClief v. Helvering,* 135 F. 2d 254, holds that the inference of indebtedness from a loan to a corporation is not rebutted by the fact that the loan was made by a sole stockholder to his corporation. The VanClief opinion at page 256 states '. . . the fact that VanClief made the advances to keep the corporation afloat rather than to liquidate it has no tendency to show that a voluntary addition to capital rather than a loan was intended. (Citing many cases including *Nicolai v. Commissioner,* 42 BTA 899, which was affirmed by this Court.) Advances are an additional contribution of capital *if they are intended to enlarge the stock investment,* but not if

they are intended as a loan. (Citing cases.) Here the parties intended the advances as a loan. This is shown not only by the testimony of the officers, *but by the entries on the books of the two companies and the consistent actions of the parties in regard to the advances, including their actions incident to the liquidation'*. (The italics were by the court.)

. . . . . .

"Here the taxpayer's stock was fully paid for by the transfers of the continuing contracts of the suppliers of fruits, vegetables and food to the two corporations. In no sense were the payments of these companies bad debts a part payment of his stock as in *Janeway v. Commissioner*, 2 T.C. 197, affirmed 147 F. 2d 602. Here was the evidence of the corporate and taxpayer's books showing the debtor-creditor relation and the notes given by the taxpayer and the corporations absent in *Cohen v. Commissioner*, 148 F. 2d 336, 337. Here the liabilities were agreed to be incurred by taxpayer in the expectancy that the corporations would be successful in business and pay off the obligations to him, unlike *American Cigar Co. v. Commissioner*, 66 F. 2d 425, 427, where the taxpayer took notes of the corporation of which he was a stockholder for advances to it, fully believing they were worthless and uncollectible."

Every essential fact in that case parallels the facts in the case at bar.

In the *Proctor Shop case, supra*, the Proctor Shop was incorporated as a result of a conference between Aaron Holtz, father, and M. H. Holtz, son, for the purpose of purchasing and operating the business known as "Proctor, Incorporated". The authorized capital stock consisted of 10 shares common stock, par value $100

each, totaling $1,000, and 990 shares of "debenture preferred stock", which were issued at a par value of $100 each. The 990 shares of debenture preferred stock were issued to Aaron Holtz, the father, and presumably the 10 shares of common stock were issued to M. H. Holtz, the son. The debenture stock provided for payment of interest at 6% per annum to be cumulative and payable before dividends on the common stock. Upon liquidation the corporation's assets were to be paid to the holders of the debenture stock prior to common stockholders, and provision was made giving general creditors superior rank to the debenture holders. The corporation paid 6% interest to Aaron Holtz, the holder of the debentures, and took the amount of the interest as a deduction in its income tax erturn. The Commissioner disallowed the deduction, claiming the payment was not interest, but dividends, and that the money paid for debentures was in reality a capital contribution. The Board of Tax Appeals held that the money paid by Aaron Holtz for the debenture stock was a loan and not a capital investment, and the Court of Appeals (9th Cir.) held:

> "In each case it must be determined whether the real transaction was that of an investment in the corporation or a loan to it. . . . Aaron Holtz was unwilling to become an investor in the corporation to be formed, but was willing to lend it money, and the transaction was placed in that form so as to preserve the corporation's credit."

In *United States vs. Collier, supra,* the Court of Appeals of the 5th Circuit held that the advances made by

a stockholder to his wholly owned corporations were not to be deemed capital contributions because they were made

"in hope of tiding them over their difficulties and saving them."

In the *VanClief case, supra,* the Court held:

"The *inference* that a *loan was intended* is the natural and *logical* inference, and the fact that VanClief was the *sole stockholder* of the corporation *did not tend to rebut it.*

. . . . . .

"The fact that VanClief made the advances *to keep* the *corporation afloat* rather than to liquidate it, *has no tendency to show that a voluntary addition to capital* rather than a loan was intended. (Citing cases)

. . . . . .

"As said by the Board in the case last cited (referring to Katzinger case):

" 'The respondent argues that all of the funds advanced by the petitioner must be regarded as additional capital contributions since Bruce-Hunt *had to have more than $1,000 with which to conduct its operations.* He cites no authority in support of this argument and we know of none." (Emphasis supplied)

In the *Moore case, supra,* the Court said:

"Nor does it change the result that she was the only financial backer of the corporation and that her loans were the permissive means of the continuance of the enterprise, during *its years of development. The statute does not provide that it is only debts, wisely contracted, which are deductible.* Redfield v. Eaton, D.C. Conn., 53 F. 2d 693. The fact

that the business had experimental and promotional features in its venture justified the decedent in believing that it might actually turn out to be very successful and that she would obtain the repayment of her loans at any time up to the time of dissolution of the corporation." (Emphasis supplied)

In the *Spreckels case, supra,* the Court said:

"The respondent admits that the advances were in fact made in the form of loans by petitioner evidenced by the company's promissory notes and were in fact treated as loans on the records of the company and the personal books of petitioner, but he argues that we should disregard those facts and hold that the advances were made as additional capital contributions for the reasons: (a) That petitioner was the sole stockholder of the Hotel Company; (b) that the advances carried with them no reasonable expectation of repayment when made because of the unprofitable operation of the hotel's business as shown by its operating losses in each of the approximate two years of its operations; and (c) that substantial portions of the advances were used for the Hotel Company's acquisition of additional fixed assets.

"*These circumstances relied upon by respondent are not sufficient to constitute the advances a contribution to capital if the real intention of the parties was that the advances should constitute loans, for the intention is the controlling factor and where the bona fides is not questioned* (as here) the facts that the lender was the sole stockholder and the corporation's business was not prospering are not a basis for disregarding the true intention or the right of the parties to create debts. William D. P. Jarvis, 43 B.T.A. 439; affirmed, 123 Fed. (2d) 742 (29 AFTR 783); Edward Katzinger Co., 44 B.T.A. 533, 536; affirmed, 129 Fed. (2d) 74 (29 AFTR 783); VanClief v. Helvering, 135 Fed. (2d) 254 (30 AF

TR 1417); See also Daniel Gimbel, 36 B.T.A. 539. The fact that certain portions of the advances were used by the Hotel Company for the acquisition of additional fixed assets, such as furniture and fixtures, operating equipment, etc., does not show, or tend to show, that the advances constituted capital contributions. Cf. Bunker Hill & Sullivan Mining, Etc., Co., 1 T.C. 1057.

"The facts set out in our findings show: That each of the notes was executed by the corporation; that the execution of each note was authorized by the board of directors of the corporation; that all of petitioner's advances were carried in an open account on books of the corporation as a liability to the petitioner; that all those advances were carried on the balance sheets of the corporation as such a liability; that all those advances were also carried on balance sheets made a part of the Hotel Company's income tax returns as such a liability; that on December 20, 1939, the amount of $2,990.27 owed the hotel by the petitioner was applied on her then indebtedness to the corporation and on the same date, the corporation transferred its assets of a net value of $113,475.76 to petitioner in partial repayment of her advances, leaving an unpaid balance of such advances in the sum of $174,138.26; and that on petitioner's books her advances to the corporation were carried as an account receivable, the unpaid balance of which in the sum of $174,-138.26 was charged off as a bad debt on December 20, 1939. All these facts show that from the beginning of the short life of the Hotel Company and continuously thereafter until near its close the advances in question were treated and uniformly regarded by the parties as loans, and, in our opinion, each advance was intended by the parties to be a loan. In the face of the facts no reasonable inference can be drawn 'that beneath the outward signs of a debt was a conception of additional contributions to . . . capital'." (Emphasis supplied)

In the *Macy case, supra,* the Court held:

> "We think the evidence in the instant proceeding establishes the fact that the advances in question were loans and were so regarded by the parties. It is true that at the time the petitioner made the advances the financial condition of the pen company was not good and these advances were made from time to time by the petitioner to enable the company to meet current obligations so as to enable it to continue in business. Even though the loans when made were hazardous we do not understand that a debt, which under all other conditions and circumstances is a valid debt, is rendered invalid because at the time the loan is made its collection at maturity would seem hazardous. If the lender has good reason to believe that notwithstanding the apparent hazards which surround the loan that the debtor will repay, then the debt is valid. The evidence convinces us that when petitioner made these loans to the corporation he had strong hopes that the corporation would ultimately be successful and would repay the loans. The facts show that the company was actively engaged in business and while it had not made a financial success, nevertheless, it was constantly endeavoring to improve that situation."

In view of these prior decisions, the decision of the Court of Appeals in the case at bar is explainable only on the hypothesis that the Court below failed to give effect to the 1949 amendment to Sec. 1141 (a), Title 26 U.S.C.A., which enlarged the scope of review of Tax Court decisions. It is impossible to reconcile the decision in the case at bar with the decisions of the Court of Appeals in the *Wilshire, Spencer* and *Proctor cases* and the decision of the Tax Court with its decision in the *Spreckels case, supra.*

The Tax Court decision in the case at bar and the adoption of the opinion by the Court of Appeals upsets well established principles applicable to the determination of the question involved. It is a departure from all that was said by the Court of Appeals of the 9th Circuit and other Courts upon that subject. Notwithstanding that all of the basic facts establishing the debtor-creditor relationship are found to exist as a fact in the case at bar by the findings of the Tax Court, it proceeded to draw unwarranted inferences from irrelevant and non-existent circumstances.

The predominant factor with the Tax Court was the alleged inadequacy of the authorized paid-in capital stock to launch the enterprise. This led to the conclusion that the stockholders must have intended to supply the additional necessary capital by capital contributions only. The Court below thus refused to give effect to the recognized right of stockholders to launch and carry on a project with borrowed capital, and their right to advance the necessary capital as loans.

The Tax Court decision is diametrically opposed to the principle which it recognized in the *Kelley* and *Spreckels cases* in which it recognized the right of the stockholder to determine whether he will supply additional funds on the basis of stock ownership or as a creditor of the corporation.

If the decision in the case at bar is allowed to stand unreversed, it will sanction the right of the Commissioner of Internal Revenue to convert loans into capital contributions merely because *in his judgment* the capi-

talization of the corporation was inadequate or because the making of a loan was unwise under given circumstances. The judgment of the Commissioner exercised posthumously will be substituted for the judgment of the taxpayer who in the very nature of things must determine for himself *at the time* of the advances whether his relationship to the corporation with respect to the additional advances is to be that of a stockholder or a creditor, a decision which he must make in advance in contemplation of a successful venture.

Re Cases Cited by Respondent

No case was cited by Respondent in the Courts below in which the facts were even remotely analogous. The cases in which the Courts disallowed *loss from sales*, the Courts found the transactions were "sham".

In *1432 Broadway Corp. vs. Commissioner*, 4 T.C. 1158, affi'd 160 F. 2d 885, the Court disallowed a deduction taken as interest because upon the facts in that case the transaction was found to be a "fiction".

In *Higgins vs. Smith*, 308 U.S. 437, a loss was disallowed because the corporation was "his corporate self". It was a typical alter ego case in which the Court found that the corporation was formed for the express purpose of obtaining the tax advantage.

In the cases cited, the taxpayers deliberately created the situation for the purpose of accomplishing a tax advantage. Corporations were reorganized by substituting debentures for stock to enable the corporations to

take a deduction for interest payments instead of distributing the earnings as dividends. The *Kelley* and *Talbot cases* are typical.

In *Janeway vs. Commissioner,* 2 T.C. 197, affirmed 147 F. 2d 602 (2nd Cir.), the corporation was reorganized with no par value capital stock. No money was to be paid for the stock. The subscribers were to make loans to the corporation and for each $1,000.00 loaned the stockholder was to receive 6/10 of one share of the capital stock *as a bonus.* This was the entire capital structure of the corporation. In answer to the taxpayer's contention that the money so advanced constituted a debt, the Tax Court said "one salient feature requires a negative answer." That feature was

> "all stock was issued in direct proportion to the amount of money put out by the stockholders."

and that the "pro rata control" of the corporation was in proportion to the money advanced.

In *Pacific Southwest R. Co. v. Commissioner of Internal Revenue,* 128 F. 2d 815 (9th Cir.), the taxpayer (not commissioner) attempted to convert the payment of dividends on preferred stock into interest on indebtedness to enable the taxpayer to take the interest as a deduction from gross income. This attempt was made notwithstanding the fact that the preferred stock was issued pursuant to and in accordance with the Articles of Incorporation authorizing the issuance of preferred stock and fixing its terms which required that dividends should be paid *out of earnings* and not as a general obligation of the corporation.

In *Commissioner of Internal Revenue vs. Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (7th Cir.), the taxpayer (not commissioner) also attempted to convert dividends paid on preferred stock into interest on indebtedness for the purpose of taking the payment of interest as a deduction from gross income. There, too, the preferred stock was issued pursuant to and in accordance with the provisions of the Articles of Incorporation which provided for the issuance of the preferred stock and pursuant to the Indiana Statute which governed the issuance of preferred stock.

In *Cohen vs. Commissioner,* 148 F. 2d 336, the Court drew the inference that the payment did not create an indebtedness because

> "no notes or other evidences of indebtedness were given to the petitioners; no action was taken by the board of directors to assume liability on behalf of the corporation with respect to loans from the petitioners or to confirm any arrangement by the corporate officers obligating the corporation for such a loan; nor were any entries covering the transaction made on the books of the corporation until some time after July 31, 1940, which was shortly before dissolution of the corporation."

The Court of Appeals did not in that case, actually determine that the absence of the evidence of indebtedness referred to above, would be fatal to the relationship of debtor and creditor. The Court said:

> "While the informality of handling the transaction might not seem to us a fatally suspicious circumstance were we free to draw inferences from the evidence independently, we cannot say that the

> Tax Court's conclusion is without substantial support."

Earlier in the decision, the Court pointed out that it had

> "but a limited power of review over the Tax Court's determination of such a question. Dobson v. Commissioner."

It is quite likely that if the same Court had reviewed the *Cohen case* subsequent to the 1949 amendment to Sec. 1141A U.S.C.A. Title 26, that it would have reversed the finding of the Tax Court.

In the case at bar, the indebtedness was from its inception evidenced by contemporaneous entries in the books of both the debtor and creditor by notes, debentures, balance sheets, etc.

In *Commissioner of Internal Revenue vs. Schmoll Fils Associated,* 110 F. 2d 611 (2nd Cir.), the corporation under a plan of refinancing exchanged the outstanding 7% preferred stock for 7% debentures to the extent of the stockholdings, and the question presented was whether the 7% payments constituted interest or dividends. The only resemblance of the substituted security to debentures was the name. The interest payments on the debentures were to be paid "exclusively from profits". The principal was *not payable in any event at a fixed or determinable time.* The principal was to be payable only at the "option of the company". The Court held:

"In short, the debenture holders do not possess the ordinary right of creditors to obtain unconditional payment of their claims at some time."

In *United States vs. South Georgia Ry. Co.*, 107 F. 2d 3 (5th Cir.), the corporation paid *dividends* to holders of preferred stock but claimed that the payments were in fact interest and deductible as such. The preferred stock itself had been issued several years prior to the controversy in payment of an outstanding mortgage indebtedness. The payments were reported in the income tax returns of both the corporation and the stockholders "as dividends and not as interest". The Court held:

"There is, thus, an entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default.

. . . . . .

"Further, we think it clear, that if resort be had to the circumstances surrounding the issuance of the certificates, and their handling and treatment since their issue, it will even more plainly appear that they were intended to be and are evidences not of debt but of company ownership."

The Court attached high significance to the fact that the preferred stock was intentionally issued to pay off and discharge the mortgage indebtedness and "thus the stockholders gave effect to the dominant purpose of the refinancing, to substitute stock liabilities for liabilities existing as debts".

These cases do not bear the slightest resemblance to the case at bar.

Re Alleged Insufficiency of the Capital Representing the Payment for Issued Capital Stock to Finance the Construction of the Plant

The Tax Court attached controling significance to the fact that the amount paid in for capital stock was only $187,000.00, whereas, the contemplated cost of constructing the plant was $700,000.00 and the ultimate cost was $1,400,000.00. From these facts, the Court drew the unwarranted conclusion that the stockholders intended to supply the difference as additional capital contributions.

No such significance can be attached to this fact, because of the recognized right of taxpayers in launching new enterprises to determine for themselves how much of their money they want to risk as stockholders and how much of their money they want to risk as creditors of a corporation. That right was recognized by the Tax Court in the decision of the *Kelley case*, 1 T.C. 457, affirmed by this Court in 326 U.S. 521, and it was recognized by the Court of Appeals, 9th Circuit, in the *Proctor case*, 82 F. 2d 792. Moreover, the Treasury Regulation referred to specifically says when advances may be treated as capital contributions.

When an existing corporation becomes in need of funds and stockholders are compelled to supply those funds, it is still the right of such stockholders to deter-

mine whether they will supply such additional funds by acquiring additional stock in the corporation or whether they will supply such funds as creditors of the corporation (*U. S. vs. Collier,* 104 F. 2d 420 (5th Cir.)).

We know of no case except the case at bar in which a Court has given conclusive or other significance to the fact that the funds resulting from the sale of capital stock are insufficient to finance the corporation in determining whether advances by stockholders create the relation of debtor and creditor. There are many cases in the books in which the debtor and creditor relationship was recognized *notwithstanding the inadequacy of the corporate capital.* In the *Wilshire case,* 175 F. 2d 718 (9th Cir.), decided after the 1949 amendment to Sec. 1141A of the Internal Revenue Code, the Court regarded as irrelevant the fact that the stockholders knew that the amount of authorized capital stock would be insufficient to pay for new construction and equipment of the project. In the *Proctor case,* 82 F. 2d 792 (9th Cir.), the capitalization was $1,000.00, but the funds needed for the acquisition of the business were obtained by issuance of debentures to the extent of $99,000.00 In the *Katzinger Co. case,* 44 B.T.A. 533 (a leading case on the subject), the petitioner acquired all of the subsidiary's capital stock of $1,000.00 but advanced the subsidiary hundreds of thousands of dollars on open account with which to carry on its business. In *Fairbanks, Morse & Co.,* 63 F. Supp. 495, plaintiff purchased all of the stock of another corporation for $7,110.00 and thereafter advanced funds on open account to the amount of $796,000.00

with which to operate and acquire plant and equipment. In the *Glenmore Distilleries Co. case,* 47 B.T.A. 213, the taxpayer owned all of the subsidiary corporation's stock in the amount of $1,000.00. Taxpayer advanced the subsidiary on open account, sold it merchandise and paid its expenses to the amount of $131,457.72. In *Commissioner vs. O.P.P. Holding Corp.,* 76 F. 2d 11 (2nd Cir.), the capitalization was $20,000.00 divided into 2,000 shares of the par value of $10.00 per share. The corporation purchased the capital stock of another corporation which became its wholly owned subsidiary paying therefor 1,000 shares of its own capital stock and issued $250,000.00 of interest bearing debentures with which it bought the assets. In the *VanClief case,* 135 F. 2d 254 (2nd Cir.), the capitalization was $1,000.00. The advances were $97,496.83.

In these cases the Courts declined to attach any significance to the fact of alleged inadequacy of corporate capital. It was a recognition of the basic right of the taxpayer to make his own decision whether he will make his advances as a stockholder or as a creditor.

Re Alleged Contributions in Proportion to Capital Stock Owned

The Tax Court seems to have concluded that the advances to the corporation by Alaska and Morris Schnitzer were in proportion to their stock ownership and from that alleged fact drew an erroneous inference and gave conclusive significance to that alleged fact.

The Court was in error both as to the fact and the significance attached thereto. The advances by Alaska and Morris Schnitzer were not at any time in proportion to their stock ownership (demonstrated at pages 11-12).

The Tax Court treated the agreement between Morris Schnitzer and Alaska (that if Alaska would take over one-half of his stock subscription he would indemnify them against any loss that might be sustained by Alaska in excess of two-thirds of the total loss, if any should be sustained) as an agreement between the individuals and the corporation to make capital investments in proportion to their stockholdings. Morris Schnitzer's agreement to indemnify Alaska for any loss in excess of two-thirds of the total loss was merely a personal guarantee which Morris Schnitzer made to induce Alaska to take one-half of his stock subscription off his hands. This personal agreement (guarantee) did not effect the extent of the liability of the corporation to each of the parties. Regardless of the existence of this guarantee, Alaska could have enforced its liability against the corporation for the full amount. Morris Schnitzer could have done likewise.

But even if the advances had been in proportion to stock ownership it would not be decisive of or even relevant to the question whether the advances were made as loans creating the debtor and creditor relation or as capital stock investments. In the *Wilshire case,* 175 F. 2d 718 (9th Cir.), the advances were made in proportion to stockholdings. In *Maloney vs. Spencer,*

172 F. 2d 638 (9th Cir.), the sole stockholder made all the advances. In *Spreckels vs. Commissioner, Para.* 49299 P-H T.C. Memo 1949, the advances were made by the sole stockholder. In the *VanCliet case,* 135 F. 2d 254, the advances were made by a sole stockholder. In the *Ohio Oil Co.,* B.T.A. Memo Decisions 42024, 1942, the advances were made by a corporation to its wholly owned subsidiary. In *Commissioner vs. O.P.P. Holding Corp.,* 76 F. 2d 11 (2nd Cir.), the advances were made by a corporation to its wholly owned subsidiary.

The Courts in those cases declined to attach significance to the fact that the advances were made in proportion to stock ownership, or that the advances were made by the sole stockholder of a wholly owned corporation. This likewise is a recognition of the right of the taxpayer to determine whether he will make advances to a corporation as a stockholder or as a creditor. There is no logical reason why the ratio of the loan to stock ownership should have any bearing on the stockholder's determination whether he will make a loan to the corporation or buy additional stock.

Re Delay in Making Ledger Entries

The Tax Court attached significance to the fact that there was some delay in posting into the ledgers the entries applying the $299,000.00 indebtedness to the payment pro tanto of Alaska stock liability of $125,000.00 and the issuance of the $174,000.00 of debentures.

The balance that was liquidated was as of November

30, 1942 (see balance shown under that date in Oregon Steel ledger, Ex. 17).

The agreement to liquidate the balance in that manner was made with R.F.C. prior to the mortgage dated December 15, 1942 (Exs. Q, R and S).

The debentures (Ex. 5) are dated January 12, 1943.

Oregon Steel accountants posted the entry in the ledger on March 31, 1943 with the notation "to record debentures issued November 30, 1942".

Alaska accountants posted the entry in the Alaska ledger on July 31, 1943. It is obvious that the posting in the ledgers to both debtor and creditor on those dates was due to bookkeeping delays. There was no reason for postponement of the entries. The liquidation of the balance had been agreed upon as of a specified date and amount. The debentures were issued on January 12, 1943 pursuant to the agreement and in the amount agreed upon, hence, there is no significance to the fact that the item was posted in the debtor's ledger on March 13, 1943, and on the creditor's ledger on July 31, 1943. At that time, there was no pending problem which would suggest the desirability of posting the entries at one time rather than another.

The entries merely confirm what had already been agreed upon and carried out.

In the *Wilshire case*, 175 F. 2d 718 (9th Cir.), the Court refused to attach any significance to the delays in making bookkeeping entries when the evidence otherwise establishes the time of the transactions.

Re Alleged Declarations That the Advances Were Capital Contributions

The Tax Court drew an adverse inference from the fact that in some communications with R.F.C. the parties referred to all moneys invested in capital stock as well as advances of merchandise and money as "contributed capital" and "additional *working* capital". The Tax Court regarded these expressions as in the nature of an admission that the advances were to be capital contributions and not loans.

An examination of each of the communications in which the terms were used read in the light of the transactions in connection with which the communications were made, demonstrates beyond question that these terms were promiscuously, inadvertently and indiscriminately used to describe generally all of the money that had been invested by the petitioners and by Morris Schnitzer, and not with the intention of making a declaration that all of the moneys so invested constituted capital stock investment.

The communications which the Tax Court referred to are Exhibits Q, R, S, T, U, AA and BB.

Exhibit Q is a memorandum that was not acted upon by R.F.C. It was rewritten as Exhibit R. Exhibit Q is signed by Morris Schnitzer only. It sets forth

> "I, Morris Schnitzer . . . hereby certify that *as of November 30, 1942* Alaska Junk Company . . . had contributed capital to Oregon Electric Steel Rolling Mills in the sum of $299,069.70, and that

> as of the same date I personally had contributed capital to said Oregon Electric Steel Rolling Mills in the sum of $138,894.11. . . . *That there will be issued to such contributors,* including myself, *common stock* in said corporation at par in *the sum of $187,700* and the *balance in debentures* of said corporation in the form heretofore submitted to Reconstruction Finance Corporation containing a stand-by as to principal and interest until after the payment in full of the mortgage loan from RFC to said Oregon Electric Steel Rolling Mills, which debentures will be taken at par; that the *authorized capital stock of said corporation is $250,000 and for* advances made *subsequent* to November 30, 1942 there will be issued either stock at par *within the amount authorized or debentures* in said sum at par."

Underneath it is a memorandum in handwriting saying:

> "I . . . will accept stock or debentures in the amount of my claim of approximately $138,984.11 in full settlement of any claim against the OESRM for materials and equipment *furnished* them."

The advances referred to in that certificate are not involved in the case at bar. They were the ones that were liquidated by applying the same to the payment of the capital stock subscription of $125,000.00 and the balance was liquidated by the issuance of the debentures in the sum of $174,000.00. These debentures are not involved in this proceeding. The indebtedness written off was incurred subsequent thereto, and is the deduction involved in this case. Therefore, the reference in the statement to contributed capital has no application to the advances involved in this case.

The exhibit demonstrates that the phrase "contributed capital" as used therein was used loosely or indiscriminately as representing both the money invested in the capital stock as well as the money invested as a loan which was evidenced by the debentures. That very instrument indicates that the term refers to both. That very instrument shows that part of the amount which Morris Schnitzer spoke of as "contributed capital" was actually invested in capital stock and a part thereof was actually a loan evidenced by the "debentures".

The concluding phrase "for advances made subsequent to November 30, 1942 there will be issued either stock at par *within the amount authorized or debentures in said sum at par*" indicates clearly that Alaska and Morris Schnitzer would have the election to make subsequent advances on either basis. They in fact elected to make the subsequent advances as loans for there never was any increase in the authorized capital stock, and none could be issued.

The words "stock at par within the amount authorized" are significant. No additional stock was ever *authorized*. The $62,500.00 which remained unissued had been reserved for Rosenbaum and Knight and even if available for issuance it certainly would not have been adequate to take up the advances of over a half million dollars made subsequent to November 30, 1942.

Exhibit R is substantially the same as Q, with some revision. There, too, the term capital investment was used. It is obvious that it was there also used inadvertently or promiscuously, and not with the intent of de-

termining the character of the advances, because that instrument, too, provides that *debenture notes were to be issued for the part of the contributions in excess of the stock subscription*. If it had been the intent to treat those words literally, then the R.F.C. would have insisted that Morris and Alaska take capital stock for all of the advances made up to that time and for the advances to be made thereafter, but this was not required. They authorized issuance of debentures for all advances in excess of the capital stock authorized and subscribed for. This instrument refers entirely to the advances that had been made up to the time it is dated, to-wit: December 29, 1942. It refers to "such contributions", meaning the advances theretofore described which had already been made, and not to subsequent contributions. Further on it says "stockholders covenant that they will receive in full payment of all *such capital investments so made* by them"; meaning the advances theretofore made. There is not a word or syllable in that memorandum which relates to advances that *were to be made thereafter*.

Exhibit S is significantly headed "Agreement as to *loans* to Oregon Steel *by its stockholders* while mortgage to Reconstruction Finance Corporation outstanding." In the body of the instrument it is provided that in consideration of the loan from the R.F.C., Oregon Steel agrees that as long as the R.F.C. loan remains unpaid it will not issue to any of its stockholders "in return for advances made or to be made by them" any preferred stock, bonds or other evidence of indebtedness except debentures in the attached form. This did not

preclude Oregon Steel from buying merchandise from Alaska on open account and paying for it in the regular course of business.

It clearly recognizes that the subsequent advances by the stockholders to the corporation were to be loans. R.F.C. required that payment be postponed until the indebtedness to it was paid. There is nothing in Exhibit S which tends to describe or construe the advances as additions to capital.

Exhibit T is a statement signed by Morris and Alaska which recites that they are owners of all of the capital stock of Oregon Steel, and that in consideration of the R.F.C. making the loan of $700,000 they will from time to time supply Oregon Steel with "additional *working capital* in such amounts as may be determined satisfactory to such agency manager by way of injection of working capital". There is nothing in that statement to suggest that the advances for "working capital" were to be as contributions to capital. They use the term "working capital" in the common understanding of the term. *"Working capital"* can be provided by means of loans as well as stock subscription.

Exhibit U is a letter addressed to Reconstruction Finance Corporation by Alaska dated December 1, 1942, and in it they say:

> "Alaska Junk Company agrees that it will assume all of the cost of such construction and equipmen which exceeds $1,200,000, and it will promptly furnish all sums of money over $1,200,00 if and when it becomes necessary to do so in order to com-

> plete the project. The above is predicated upon the Reconstruction Finance Corporation financing an additional $100,000 over and above the $600,000 already authorized. If Reconstruction Finance Corporation does advance any monies beyond $600,000 Alaska Junk Company agrees to match such dollars."

Now, of course, R.F.C. was not contributing to the capital of Oregon Steel, it was merely making a loan. The additional money which Alaska undertook to provide was also advanced as a loan. In other words, they were to be co-lenders in the proportions outlined in the letter. There is nothing in that letter to suggest that Alaska's "advance" was to be upon any basis other than the R.F.C. "advance", or to suggest that Alaska was to make advances by way of further subscription to capital stock.

The Tax Court also drew an unwarranted inference from the letters dated respectively, December 23, 1942 and March 18, 1943, Exhibits BB and AA. In the former of the two letters, Morris Schnitzer wrote to the manager of R.F.C. submitting for approval additional plans and data pertaining to the construction of the mill and in it called attention to estimates of additional costs. The Tax Court drew an adverse inference from the acknowledgment of the fact by Morris that the plant was going to cost more money. We fail to see how that could possibly throw any light upon the question as to whether the advances which had been made were loans or capital investments. The reasons for the additional costs were well known. They were due to the rapidly

rising costs due to the war conditions and in part to delays beyond their control. On the second page of the letter, he asks the approval of the increase in the loan from $600,000 to $700,000 and he says:

> "the balance necessary to complete this plant will be financed by the OESRM (Oregon Steel) without R. F. C. assistance."

There is no suggestion in this sentence that the balance will be furnished by further contributions to capital. The only inference to be drawn from that sentence is that the additional financing would be furnished on the same basis as theretofore, to-wit: loans and advances.

In the letter of March 18, 1943, Exhibit AA, Morris again wrote to R.F.C. complaining about its failure to give his former request attention and the failure to reply. He complains bitterly about that condition and in order to impress them with the situation he says:

> "In fact we never originally intended to put in over (and it should not have been necessary) the $500,000 we were supposed to put in as our share in the capital investment. As of February 28, we have in this job over $700,000 of our own money."

Here again the Tax Court drew unwarranted inferences from the language just referred to. This letter was addressed to the R.F.C. It knew from the financial statements and all the other documents including the Exhibits Q, R, S, and T, just what Morris meant by the use of these terms. They knew that the money referred to had been paid for capital stock to the extent of $187,000 and the balance for advances or loans, part of which

had been evidenced by debentures. They understood fully that the term "capital investment" as used by Morris meant that it represented all of the monies that the stockholders had put into the venture, both by payment for capital stock and by advances. It was error of law for the Tax Court to infer that this was a representation that they had put in all of that money in payment of stock ownership. The Tax Court had to treat that language in the same manner and understand it in the same way that the R.F.C. understood it and in the same manner that Morris intended it should be understood. The Tax Court was not justified in attributing a meaning to those words contrary to the meaning which both the sender and the recipient of the letter attached to the words.

In any event, it was Morris who made these inadvertent and promiscuous statements. They were not made by petitioners and under elementary rules of evidence, Morris could not bind or prejudice petitioners by his erroneous characterization of the advances.

These statements were not made to the Commissioner of Internal Revenue in connection with any proceeding involving the determination of petitioners' tax liability. Commissioner was not led into making any determination by Morris' statements. There is no element of estoppel involved.

This is the documentary evidence which the Tax Court says emasculates the vast amount of evidence, documentary and oral, which is uncontradicted and evi-

dence that is stipulated in the record as to the intention of the petitioners in making advances.

Nobody was misled by the promiscuous and indiscriminate use of those words. The very instruments in which the words were used disclose that the so-called capital investment or contribution was represented by stock subscription of $187,700 and the balance was to be evidenced by debentures. The same instruments also point out that the total authorized capital stock is $250,000 so that R.F.C. to whom the representations were made was aware that the term was being promiscuously used and did not regard the term as indicating that all the advances were to be evidenced by the issuance of capital stock.

If R.F.C. had understood the term to mean actual contributions to capital it would not have permitted the subsequent advances to be evidenced by debentures or in part by additional capital stock up to the amount of the authorized capital. It would have insisted that the capital of the corporation be increased by amendment of its articles of incorporation to an amount large enough to encompass all of the advances and would have insisted that stock be issued in payment of those advances to remove those advances from the category of liabilities. It did not do so, but sanctioned the issuance of debentures which are evidence of debts.

Certainly, the Commissioner of Internal Revenue was not deceived in any manner by these statements. They were not made to the Internal Revenue Bureau

in connection with tax returns, or at all. It is a patent attempt by the Commissioner to capitalize on an inadvertent use of a phrase in a transaction wholly unrelated to any tax problem.

Respectully submitted,

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